

Policy Questions
MTC Telecommunications Apportionment Project
Draft – for discussion purposes only 7-12-05

- I. Does the apportionment rule of section 17 work for telecommunications and similar industries? If not, what are the problems?
 - A. Inability to adequately define or cost-effectively determine the cost of performance (COP) for these industries? For example, there is uncertainty in the definition and application of "direct costs," accounting difficulties in identifying costs of performance for each receipt, and the fact that common costs of performance may be difficult to isolate and associate to the different varieties of receipts common to this industry. Do these difficulties tend to produce or allow arbitrary results?
 - B. Failure to reasonably reflect the location of these industries' business activity?
 1. Assuming COP could be adequately determined; does the section 17 rule which assigns sales to the state with the greater COP reasonably reflect the location of business activity for these industries? Or does the "network" character of these industries' capital infrastructure essentially spread the COP so ubiquitously and thinly across the states in which the industries conduct business activity that to assign receipts to the single state with the greater COP, perhaps only greater by a fraction of a percent, is essentially an arbitrary result? Because of the wide distribution of COP, minor alternatives in the definition of a "direct cost," could have dramatic effect as to which of the states is entitled to the assignment of a sale under a COP analysis. Because of the all-or-nothing character of section 17, fine-line interpretations of any rule, in practice, could create great practical uncertainty as to whether one state or another state is the appropriate numerator state in the sales factor.
 2. Assuming COP could be adequately determined; does the location of those costs (aside from application of the "greater of" rule) have any theoretical connection to the extent of the industries' business activity in the various states, within the meaning of section 18?
 - C. Increased opportunity for manipulation of the apportionment result within this industry?
 - D. Other?
- II. Which industries are affected by these problems?

1. “Telecommunications service?” E.g. long distance (international, interstate and intrastate?) and local transmission of residential and business communications (including voice, data, text, sound and video communications)? Does the term include “enhanced services” such as the application of security protocols?
 - (1) Is there a definition of “telecommunications service” that fits our area of concern?
 - (a) FCC definition,
 - (b) SSTP definition,
 - (c) U.S. Census Bureau, NAICS definition (or the new NA Product Classification definition), or
 - (d) Alliance for Telecommunications Industry Standards definition (which have been approved by the American National Standards Institute)?
 - (2) Resellers? E.g. service provided by telecommunications resellers, through pre-paid calling cards, or by hotels?
 - (3) Mobile, Paging or Private Communications Service (PCS)?
 - (4) Communications services provided by other than traditional telephone companies, or using non-traditional technologies? E.g. cable, radio, satellite, VOIP, power lines, and any other?
2. Related fees? E.g. universal service fees, service initiation fees and disconnection fees?
3. Ancillary services? E.g. directory assistance, voice mail, detailed billing, teleconferencing, or vertical services (3-way calling, caller id, call forwarding, etc.)?
4. Wholesale, as well as retail communications service? E.g. network access service provided by one telecommunications company to another; or services sold to resellers, pre-paid calling card vendors, some pay phones and hotels?
5. Retail services used as an input into other services? E.g. the service of transmitting radio and television audio and video programming, or internet backbone services sold to internet access providers?
6. Other business “similar to” communications service? E.g., services that may be “bundled” with telecommunications services (whether they are in fact sold in a bundle or alone?)?

- (1) Internet access services?
 - (2) Web search portals?
 - (3) Data processing services?
 - (4) Information Services that provide information content (data, news, video, audio, law searches and retrieval, etc.)? Should there be a difference if the information service is part of the services provided by a general telecommunications company, or if the information service does not have any other "telecommunications" service other than providing information?
- 7. Are the problems specific to a defined industry classification (e.g., that falls within a standard industrial code), or do they affect any taxpayer that engages in the impacted activity, regardless of industry classification.
 - 8. Is it unfair to modify the application of Section 17 to telecommunications (and similar services) without making the change applicable to all services? Or are the problems of this industry type sufficiently distinct that we need not address the issue of other services? See also Policy Question V.A.4. (economic neutrality as a goal). If the lines between telecommunications, information services, cable, entertainment services and other types of communication services offered over other platforms are being blurred, should the rule apply as broadly as possible to all such services? Or would re-drawing the line just re-define inequities, and lead to complications and litigation?

III. For the affected industries, are the problems best addressed by:

- A. Adopting a regulation to clarify COP for these industries pursuant to section 17?
[If so, go to Section IV.]
- B. Adopting a new special apportionment rule for these industries, pursuant to section 18, that either:
 - 1. Clarifies the COP calculation, and modifies the "greater of" rule to reflect the COP in each state's numerator on a pro-rata basis? Assuming COP could be adequately determined, but the "greater of" rule were abandoned in lieu of a pro rata COP, such a practice would be by definition a variation from section 17 and the application of a special rule under section 18. Or -
 - 2. Creates a new special apportionment rule based on something other than COP?

[If so (either III.B.1. or III.B.2.), skip to Section V.]

IV. If the problems are best addressed by continuing to apply section 17 COP apportionment rules to the affected industries, but issuing clarifying regulations (III.A.) –

A. Under the MTC Reg IV.17.(2), sales are assigned to the state where the greatest “income producing activity” is performed, based on the COP, and “the term ‘income producing activity’ applies to each separate item of income.” In the case of services covered by the rule, would each “item of income” refer to:

1. Each call (or each use of service)? Location of ‘income producing activity’ is determined based on the location of the costs of performance. Under the current regulation, cost of performance is limited to "direct" costs. What is a "direct cost?" Costs of performance associated with a specific call would include the variable costs associated with the call, but would not necessarily include fixed, common costs such as those related to the headquarters or facilities infrastructure. If not already a part of "direct costs" should a "full absorption" method be used to assign fixed and common costs to the services to which those costs relate?
2. Each service category? E.g. long distance service, local service, internet access? Costs of performance associated with whole service categories could include both variable costs of providing the service, plus the fixed costs associated with the service. Costs would not necessarily include fixed costs that are common to more than one service, but they could. If they did, would a proration of such costs between service types be necessary?

B. Are the variable costs of performance fully determinable? If variable costs are determinable, are they so relatively insignificant as to be arbitrary? If not determinable, should the inclusion of variable costs be limited to those that can be determined, such as payroll or property costs associated with the customer’s service address? Should annual depreciation costs rather than the value of the entire property be considered in determining cost of performance? Should depreciation costs be considered, given that under GAAP, depreciation is not ordinarily considered a "direct" cost?

V. If the problems are best addressed by a new special apportionment rule for the affected industries pursuant to section 18 (III.B.) –

A. What should be the goals of the special rule?

1. Reflect the contributions of the market state(s) (Is the “market state” defined as the state where the buyer purchases the service or the state where the buyer consumes the service?)
2. Simplify the computation by incorporating elements that can be geographically located,

3. Avoid discriminating against either out-of-state commerce or purely in-state commerce,
4. Promote economic neutrality by treating all firms engaged in similar business similarly,
5. Minimize opportunities for manipulation of the apportionment result,
6. Minimize the fiscal impact to the states,
7. Create a consistency of result between the states, and between taxpayer in a single state, that may be difficult to achieve under the cost of performance rule, and/or
8. Minimize the administrative burden to the taxpayer and the states?

B. What is the best method for satisfying these goals?

1. Would a rule based on cost of performance, but modified to reflect the COP in each state's numerator on a pro-rata basis, (such as that used in the sales factor for banks and financials) best satisfy the Committee's goals? If so, would this create greater pressure to define problematic concepts such as what constitutes a cost of performance and what constitutes a "direct cost?" Would these efforts to refine the cost of performance rules for consistency have spill-over effect into other services, or be limited to the industry? Would a pro-rata COP create its own distortions, where a particular service has a very high concentration of costs in a given state, but where the utilization of that service is in many states?

Or -

2. Would a rule based primarily on customer "service address" (where the service originates or terminates and is "charged;" regardless of where the service is billed or paid) best satisfy the Committee's goals? If so:
 - (1) How should "service address" be defined? Can it be defined in a way that avoids unreasonable administrative cost for companies that are currently using COP?
 - (2) What if service address is not reasonably knowable for 100% of the items of income (revenue sources or types of services)?
 - (a) For types of services for which service address is typically reasonably knowable, should there be "back-up" rules that apply in isolated situations where the service address is not known? E.g. "the origination point of the signal first identified by either the seller's system or in information received by the seller from its service provider, where the system used to transport such signals is not that of the seller," and then "the location of the customer's place of primary use."

- (b) For types of services for which service address typically is not reasonably knowable (e.g., it may be knowable, but not cost effective to find out), are there reasonable proxies for service address? E.g.:
- Large corporate customers?
 - Residential customers and small and wholly in-state businesses? (e.g. billing address?)
 - Network access (or is network access service the use or leasing of equipment rather than the provision of a telecommunications service?)
 - Pre-paid calling cards (See Policy Question V.A.1. - is the “market state” simply the state of purchase or is it the state of use?),
 - Directly connected data services?

(3) For types of services for which there simply is no fixed service address, are there reasonable alternative bases for apportionment? When is billing address an adequate proxy?

C. Is there also a need to clarify or revise the treatment of outer-jurisdictional property for purposes of the property factor?

1. Communications companies have invested capital in outer-jurisdictional property and expect a rate of return on such investments. Does the fact that OJ property is not physically located in a particular state mean that no state should tax any income attributable to the property? Is reallocation of the “income earned on this investment” inconsistent with business practice and economic theory? Or is it necessary in order to determine in which state that “income earned on the investment” should be taxed?
2. If it is proper to tax even income attributable to outer-jurisdictional property, would that best be achieved by
 - (1) A “throw-out” rule excluding the property from both the property factor numerator and denominator? Would a throw-out rule produce substantially the same mathematical result as evenly distributing the value of the OJ property over the numerators of all the taxpayer's property (and members of its unitary group in combined reporting states), including property that is not directly related to a service for which the satellite is used? For example, would a throw-out rule effectively assign the value of a satellite to the property of a unitary book seller?
 - (2) A “system-spread” rule under which OJ property is proportionately assigned to the property in the telecommunications system that uses that

property? How would "system" property be defined and distinguishable from other property? Is there a "system" proxy that might work?

D. How should the rule be applied?

1. Does the rule apply to all revenues of an entity that is engaged in a business which comes within the scope of the regulation?
2. Or just to that portion of an entity's revenues from the performance of the business that comes within the scope of the regulation? (E.g., retaining cost of performance rules for other services, and treating sales of tangible personal property (e.g. security systems) in the usual manner.) Do the problems presented by this industry relate to all services? For example, are consulting services in this industry sufficiently different than consulting services generally to justify a different rule than COP?
3. Do the rules apply only to a defined industry classification (e.g., that falls within a standard industrial code), or to any taxpayer that has an activity described by the special rule?